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CITATIONS

584033—44

In the Supreme Court of the United States

OCTOBER TERM, 1943

No. 840

CLAIRE A. PEKRAS, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

No. 841

JOHN PEKRAS, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the Tax Court of the United States (No. 840, R. 22–26) is unreported. The Circuit Court of Appeals affirmed the decisions of the Tax Court without opinion (No. 840, R. 35; No. 841, R. 19).

JURISDICTION

The judgments of the Circuit Court of Appeals were entered on December 16, 1943. (No. 840, R. 35; No. 841, R. 19.) Petitions for rehearing were denied on February 23, 1944 (No. 840, R. 51; No. 841, R. 35). A joint petition for writs of certiorari was filed in this Court on April 3, 1944. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Is a leasehold property of a character which is subject to the allowance for depreciation provided in Section 23 (l) of the Internal Revenue Code so that it is not a "capital asset" within the meaning of Section 117 (a) (1) of the Internal Revenue Code?

STATUTE AND REGULATIONS INVOLVED

The pertinent statute and regulations are set out in the Appendix, *infra*, pp. 12–14.

STATEMENT

1. In the case of Claire A. Pekras, wife of John Pekras, the facts as stipulated (R. 14–22) and as found by the Tax Court (R. 22–24) may be summarized as follows:

One Ely, the owner of certain land, leased it in 1920 to Sadaris for a term expiring September 30,

1945. Under the agreement the lessee erected the Capitol Theater which, on expiration of the lease, was to revert to the lessor. The term of the lease was later extended to September 30, 1955. In 1930, the interest in the lease, theater building and equipment was bought by Warner Bros. Pictures, Inc. On November 23, 1934, the original lease, the first extension and all personal property, furniture, and equipment in the theater was sold to the taxpayer, Mrs. Pekras. (R. 18–19, 23.)

As part of the consideration for the sale the taxpayer cancelled the balance of unpaid rent due her under the lease from Warner Bros. Pictures, Inc., in the amount of $22,565.16; she assumed and paid the balance of unpaid rent due to Sadaris from Warner Bros. Pictures, Inc., in the amount of $11,934.72; and paid Warner Bros. Pictures, Inc., $25,000 in weekly installments of $100, making a lump sum purchase price or cost of $59,499.88 (R. 18, 23).

While the sale of November 23, 1934, was being negotiated, the taxpayer on August 30, 1934, obtained from Ely an additional extension of the term of the lease to September 30, 1959. She paid $1,500 attorneys' fees for services in connection with negotiations with Ely for extension of the lease and in other legal matters connected with the theater and allocated $1,400 of this fee to services in connection with the lease. This $1,400 was deducted by her and allowed by the Commissioner as an ordinary and necessary business

expense in 1934. It was again set up in her return for 1940 as cost of the leasehold. (R. 19, 23–24.)

In 1940 the taxpayer owned the lease running to September 30, 1959, the building, subject to the reversionary interest of Ely, owner of the fee, and full title to all furnishings and equipment of the theater (R. 15). On May 1, 1940, these were sold to Edith Amster for $180,000, $105,000 being allocated in the agreement for the lease and $75,000 for the equipment and building rights. In 1940 she received $26,850 on the sale price of $105,000 for the lease, of which $23,807.08 was profit. She reported 50% of the profit as taxable gain on the sale of a capital asset (R. 20, 25) under Section 117 (b) of the Internal Revenue Code (Appendix, *infra*).

The Commissioner taxed the entire profit as an ordinary gain (R. 10–11), and determined a deficiency in income tax for the year 1940 of $3,469.32 (R. 9) which the Tax Court sustained (R. 27). The Circuit Court of Appeals affirmed (R. 35).

2. In the case of John Pekras, husband of Claire A. Pekras, the facts as stipulated (No. 840, R. 14–22) and as found by the Tax Court (No. 840, R. 24–25) may be summarized as follows:

In 1913 certain land was leased by the owner to Dachtler & Dachtler for a term expiring in November 1933, later extended to January 1, 1941.

In 1915, the land was sublet to one Bannon for the unexpired term and the erection of a theater. In 1922–1923, the New Rivoli Theater was erected on the premises by the sublessee. In 1922 Bannon assigned his interest in the lease to The Bannon Theatre Company. The lease provided that building improvements would revert to the owner of the fee on expiration of the term on January 1, 1941. John and Claire Pekras owned the majority of the shares of The Bannon Theatre Company. (No. 840, R. 24.)

In 1937 the fee owners leased the premises to John Pekras for a term January 1, 1941, to December 31, 1965. He paid $4,500 to acquire outstanding adverse interests. In April 1940, The Bannon Theatre Company was the owner of the lease and owned the theater building, subject to the rights of the fee owners, and had full title to the theater equipment. The $4,500 was capitalized by John Pekras but no amortization thereon was claimed in his 1937, 1938 or 1939 tax returns. (No. 840, R. 25.)

In 1922 John Pekras became the lessee of part of a three-story building, including the Lincoln Theater, for a term ending August 31, 1937. In 1932 a new lease was made for a term expiring December 31, 1958, later changed to December 31, 1957. No consideration was paid for this lease beyond annual rental. In April 1940, John Pekras owned the lease expiring December 31, 1957, all furnishings and equipment in the theater,

and the right to use building alterations and improvements made by him for the term of the lease. His unamortized cost of the equipment was $18,643.87. (No. 840, R. 25.)

On May 1, 1940, John Pekras and The Bannon Theatre Company sold their respective interests to Edith Amster, giving separate leases for the unexpired terms and separate bills of sale of the equipment in the theaters. The entire sale price of $49,000 for the New Rivoli Theater was for the lease alone. Of that amount John Pekras received $12,525 in 1940, of which $10,112.10 was profit. The sale price of the Lincoln Theater was allocated $60,000 for the lease and $20,000 for the equipment and building rights. Of that amount John Pekras received $15,339 in 1940, of which $13,794.56 was profit. (No. 840, R. 25.) He reported 50% of the profit as taxable gain on the sale of a capital asset (No. 841, R. 9) under Section 117 (a) (1) of the Internal Revenue Code.

The Commissioner taxed the entire profit as an ordinary gain (No. 841, R. 9) and determined a deficiency in income tax for the year 1940 of $4,158.06 (No. 841, R. 8) which the Tax Court sustained (No. 841, R. 12). The Circuit Court of Appeals affirmed (No. 841, R. 19).

ARGUMENT

There is no conflict of decisions and none is pointed out by the petitioners. The decisions be-

low are plainly correct, and further review by this Court is unnecessary.

1. Petitioners claim that their sales of the leases constitute sales of capital assets, and that, accordingly, under Section 117 (b) they are taxable only upon 50% of the gain realized. But "capital assets" are so defined in Section 117 (a) (1) as to exclude "property, used in the trade or business, *of a character* which is subject to the allowance for depreciation provided in Section 23 (l)." [Italics supplied.] Section 23 (l) (Appendix, *infra*) grants a "reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence." This allowance is customarily referred to as "depreciation."[1]

Many cases now establish that a leasehold is subject to an allowance for depreciation or exhaustion over the term of the lease. *Kaufman-Straus Co.* v. *Lucas,* 12 F. 2d 774 (C. C. A. 6th); *Fackler* v. *Commissioner,* 133 F. 2d 509 (C. C. A. 6th); *Bonwit Teller & Co.* v. *Commissioner,* 53 F. 2d 381,

[1] The statute uses the word "depreciation" and describes it as including "exhaustion." While as a matter of practice the word "amortization" is frequently used to describe the annual loss in value of a contract or lease, it is not used in the technical sense but as representing exhaustion over a fixed period of time. It is significant that depreciation of leaseholds and court decisions relating thereto are treated under Section 23 (l) in Commerce Clearing House Federal Tax Service (1944), Vol. I, par. 216, pp. 1770–1773. That has also been the practice in the past.

383–384 (C. C. A. 2d), certiorari denied, 284 U. S. 690; *Davison* v. *Commissioner,* 60 F. 2d 50, 52 (C. A. A. 2d); *Helvering* v. *Lazarus & Co.,* 308 U. S. 252, and cases cited (p. 254). This conclusion is obviously correct, inasmuch as a lease—as distinct from the fee interest in lands—is of temporary value which decreases from year to year as the end of the term approaches.

Petitioners contend that these principles are inapplicable to them because they incurred no capital expense in procuring their leaseholds, and accordingly could obtain no allowance for depreciation. Even assuming this to be true,[2] it is immaterial, for the statute excludes from the definition of capital assets "property * * * *of a character* which is subject to the allowance for depreciation * * *." [Italics supplied.] The emphasis is upon the "character" of the property and not upon the right to any deductible allowance in the individual case. If the general character

[2] Only with respect to the Lincoln Theater, however, was there no cost basis. Claire Pekras had an admitted capital cost of $1,400 for attorneys' fees in acquiring the Capitol Theater lease (No. 840, R. 19, 23–24). In the acquisition of the leasehold she assumed and paid $11,934.72 of back rent due from Warner Bros., Inc., to Sadaris (No. 840, R. 18, 23). Assumption of that liability was a capital expenditure to acquire the lease and was subject to an allowance for depreciation. John Pekras also had a capital cost of $4,500 in acquiring certain outstanding adverse interests in connection with acquiring the Rivoli Theater lease (No. 840, R. 25).

of the property is of a depreciable nature it is excluded from the definition of a capital asset, and a leasehold is certainly of that general character.

The petitioners contend that in Ohio a leasehold creates an interest in real estate and that land is not subject to an allowance for depreciation. We agree that land is not subject to depreciation, but the petitioners were lessees and neither acquired nor sold any fee interest in the land as such. The fact that the Ohio courts regard a long-term lease as in many respects like the conveyance of a fee is not material, since the federal statute is controlling. *Weiss* v. *Wiener,* 279 U. S. 333, 337. Nor does the fact that in the selling agreements a separate value was ascribed to each lease and, in the case of the Capitol and Lincoln Theaters, a part for equipment and building rights, create a non-depreciable interest in land. It is the lease itself which is subject to depreciation. The petitioners are here confusing a fee interest in realty with a leasehold.

2. The petitioners argue that the Commissioner by his regulations has deliberately caused "taxpayer entrapment." This argument rests on the fact that a regulation issued under Section 23 (a), rather than under Section 23 (l), instructs a lessee that he may deduct annually over the period of his lease the proper proportion of the cost of erecting buildings or making permanent im-

provements, and states that such deduction "shall be in lieu of a deduction for depreciation."[3] But the integration in one regulation, for purposes of convenience, of the rules governing deductions for lessees[4] does not mean that the amount allowed is not "for the exhaustion, wear and tear of property" under Section 23 (l)—as it obviously is in fact. The only deductions under Section 23 (a) which could be applicable to this case are "business expenses" and "rent." But a lessee is also entitled to a deduction for cost spread over the term of the lease, and such exhaustion, as pointed out above, is the same as depreciation, the words being used as correlatives in Section 23 (l). The phrase "in lieu of a deduction for depreciation" was designed to make it clear that the taxpayer could not take two deductions for the same item of cost—one in the form of exhaustion and one in the form of depreciation (i. e., wear and tear) of the physical property. It is not to be construed—nor can it be in view of the plain language of Section 23 (a) and (l)—as denying to lessees the deduction defined in Section 23 (l); it merely describes the means of taking the deduction. See *Duffy* v. *Central R. Co.*, 268 U. S. 55.

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[3] The regulation is quoted in the Appendix, *infra*, pp. 13–14.

[4] Since rentals are deductible under Section 23 (a) but capital expenditures are not so deductible, and since leases involve both rentals and capital expenditures, it was appropriate to make the distinction in discussing rentals under Section 23 (a) in the regulations.

3. The conclusion of the Tax Court is not contrary to the stipulated facts or to the facts as found. The conclusion reached was that a leasehold is property of a character which is subject to exhaustion or depreciation allowed by Section 23 (l) and therefore is expressly excluded from classification as a capital asset. As pointed out above, it is immaterial that John Pekras has no cost for the lease of the Lincoln Theater.

CONCLUSION

The petition for writs of certiorari is without merit and should be denied.

Respectfully submitted.

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APRIL 1944.

APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—

(1) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including * * * rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

(l) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *

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(26 U. S. C., Sec. 23.)

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) *Capital Assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable

year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l);

* * * * *

(b) *Percentage Taken into Account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

* * * * *

50 per centum if the capital asset has been held for more than 24 months.

* * * * *

(26 U. S. C., Sec. 117.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.23 (a)-10. *Rentals.*—If a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run. Taxes paid by a tenant to or for a landlord for business property are additional rent and constitute a deductible item to the tenant and taxable income to the landlord, the amount of the tax being deductible by the latter. The cost borne by a lessee in erecting buildings or making permanent improvements on ground of which he is lessee is held to be a capital investment and not deductible as a business expense. In order to return to such taxpayer his investment of capital, an annual deduction may be made from gross income